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SUBJECT: Accession Countries And The Euro: Convergence Criteria Cause Dilemmas

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¶1. (SBU) Summary: EU member states and acceding countries (ACs) are beginning to face the dilemmas that EU economic rules are likely to present them both as soon as accession occurs in May 2004. EU rules require ACs to adopt the euro as soon as they fulfill the convergence criteria on inflation, public finances, exchange rate stability and long-term interest rates.

¶2. (SBU) Meeting these criteria, however, could be problematic for ACs: Catching up to per capita income levels in other EU countries is likely to generate relatively higher inflation; forcing inflation down could slow down growth; increasing government expenditures for infrastructure can bolster long-term growth, but they could generate higher annual deficits than permitted by the EU rules; and two-year-participation in the exchange rate mechanism (ERM II) could be a useful "waiting period" to find an appropriate equilibrium rate, but also could subject AC's to speculative currency attacks and deprive ACs flexibility to adapt exchange rates in response to structural changes and economic shocks.

¶3. (SBU) These dilemmas might be resolved by watering down the rules, allowing a broad interpretation, or by postponing participation in EMU. The ACs generally prefer the second option; the current EU member states the third. These alternatives have provoked intense political discussion and speculation.

¶4. (SBU) A first clear signal of which way the official line is headed should be when the European Central Bank (ECB) and the European Commission present their first convergence reports for the ACs, most likely in the fall 2004. We expect that the rules will remain the touchstone of the process, but also note that the final decisions on joining the euro are taken at the political level. As the decision was for several of the current members of the Euro Group, pragmatism is likely to rule the day. While EU Finance Ministers want ACs to have a "solid foundation" for their economies that will lend confidence to the euro, they also probably wouldn't like to see economic fires raging in their neighborhood either. End summary.

ACs to EMU: No Opting Out
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¶5. (SBU) After signature of the Accession Treaty in April 2003 for ten new member states to join the EU on May 1, 2004, attention is now turning to the next big step: entry of the Accession Countries (ACs) into Economic and Monetary Union (EMU). When the ACs join the EU in 2004, they will become "member states with a derogation" concerning their participation in EMU. This means that they are expected to adopt the euro as soon as they fulfill the convergence criteria. They will not have the right to "opt out" as the UK and Denmark did through separate protocols.

Nominal Convergence: By the Rule Book
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¶6. (SBU) In order to join the EMU, ACs need to fulfill the convergence criteria set out in the Treaty on European Union. This is referred to as "nominal convergence." The criteria are:

--Achievement of a high degree of price stability, apparent from an inflation rate close to that of, at

most, the three best performing member states;

--Sustainability of government finances apparent by the absence of an excessive deficit in accordance with Article 106(4) of the Treaty;

--Observance of the normal fluctuation margins provided for by the exchange rate mechanism of the European Monetary System (EMS) for at least two years with no devaluation against the currency of any other member state; and

--Durability of convergence achieved by the member state and of its participation in the exchange-rate mechanism of the EMS being reflected in the long-term interest rate levels.
¶7. (SBU) The European Commission and the ECB will assess each AC's performance in terms of these criteria in so-called convergence reports. Commission officials report that they are "leaning toward" doing the regular convergence reports for Sweden before May 2004, then prepare convergence reports for the ACs in the fall, after they have become EU members. These officials admit that these reports will "have to be clear" on the criteria the Commission expects ACs to fulfill to adopt the euro. If the ACs were to join ERM II towards the middle or end of 2004, the criteria could be met in 2006 at the earliest, with data from 2005 and 2006 used as a reference year. Thus, the first ACs could join EMU in 2007 or early 2008.

Exchange Rates: A Tricky Business

¶8. (SBU) Interpretation of the exchange rate criterion is tricky business. The Treaty refers to normal fluctuations of the EMS. Protocol No.6 on convergence criteria further specifies that the "normal fluctuation margins" must be respected "without severe tensions." The EMS had a fluctuation band of +/-2.25% that was widened to +/- 15% in August 1993. In 1998 the EMS was replaced by ERM II which has a band of +/-15%.
¶9. (SBU) The European Monetary Institute's (EMI, the predecessor of the ECB) 1998 Convergence Reports provides some insight on its interpretation of these provisions. The EMI noted that the widening of the band makes interpretation of "normal fluctuation" "less than straightforward." But, it decided to "put emphasis" on exchange rates being "close to the central rates." Similarly, "severe tensions" was considered by examining deviations from the central parities and using indicators of exchange rate volatility and short-term interest rate differentials.
¶9. (SBU) An ECB official stated that he interprets the Treaty as referring to the narrower band of the original EMS. Similarly, a Bundesbank official told us that in his view it would not be sufficient for ACs' currencies to fluctuate in the wider band of ERM II, but should remain more or less within the +/-2.25% band. He also admitted that appreciation over the band would be less of a problem than depreciation. While the Commission has not been very clear about its interpretation of the Treaty, in May Commissioner Solbes let slip that the narrower band is also what he would expect from ACs. Privately Commission experts admit that this has been their guiding rule to date.

¶10. (SBU) Getting the equilibrium exchange rate right between the ACs national currency and the euro is important for ACs and the ECB. For the ACs it is a question of price competitiveness and long-term growth prospects. For the ECB it could be a question of inflation. Once in the ERM II, intervention at the margin to keep a currency in its band is, in principle, automatic and unlimited. Thus, the rate better be right for the sake of the ECB the national central banks that would be drawn into such intervention or its financing potentially increasing money supply The ECB, however, can suspend such intervention if it were to conflict with its primary objective of price stability. Doing so would likely be perceived as a vote of no confidence in the exchange rate. Therefore it is no surprise that ECB officials reportedly are working with AC central bankers to ascertain the appropriate exchange rate at which to fix their currency against the euro.

Inflation: A Question of Catching Up or Being Too Tight?
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¶11. (SBU) The inflation criteria present another set of problems. Upward pressure on the price levels in ACs is likely to come from macroeconomic factors such as higher productivity growth and the associated Balassa-Samuelson effect (relatively higher productivity and wage growth in tradable goods contributing to upward price pressures on non-tradable goods and services and

their associated wages) as well as from price liberalization and deregulation. These factors lead to inflation rates that are likely to temporarily remain above the EU average. Inappropriate macroeconomic and wage policies combined with structural weaknesses in the ACs economies also exert upward pressure on price levels. Divergent inflation rates between EU member countries and ACs can be expected to remain a problem until real convergence has been achieved.

¶12. (SBU) Given the current very low inflation rates in some euro zone members, the inflation criterion would require ACs to achieve inflation rates well below 2%. The European Commission's spring forecast, for example, projects average annual inflation of 1.7% for the euro area in 2003 compared to 2.7% in the ACs. The average inflation rate of the "three best performing member states" would be 1.1%. According to the Commission's forecast, only Lithuania and Poland would meet that target in 2003. Tight monetary policies needed in the other ACs to achieve the inflation target could have a negative effect on the ACs' economic growth.

¶13. (SBU) The convergence criteria were designed for developed, i.e. largely converged countries, and not for transition economies. As ACs have generally experienced real currency appreciations of 2-3% annually there is a conflict between the inflation criterion and the exchange rate stability required in ERM II. Real appreciation takes place either through a nominal appreciation of the currency or via relatively higher inflation than in the country's main trading partners. The convergence criteria do not allow the ACs either. More generally, with full capital mobility and only one instrument (interest rates), the central bank cannot target the inflation rate and the exchange rate simultaneously.

¶14. (SBU) Commission officials point out that persistent differences in inflation rates between countries are a risk for fixed exchange rate systems. They argue that keeping flexible exchange rates for the ACs could limit the risk of overheating through the option of a nominal appreciation and interest rates that are in line with the national economic situation.

Long-Term Interest Rates: Market Expectations

¶15. (SBU) ACs have already experienced convergence of long-term interest rates towards the levels of EMU members. This may partly be due to market expectations that these countries will join EMU soon, resulting in investments in ACs bond markets (the so-called "convergence play"). However, the drop in interest rates is also the result of a considerable volume of foreign direct investment, the gradual stabilization of domestic price levels and slowing economic growth.

The Fiscal Side: SGP Rules

¶16. (SBU) The absence of an excessive deficit according to Article 106(4) of the Treaty is defined as a general government deficit of no more than 3% of GDP and a debt level of no more than 60% of GDP. These are the reference values in the Treaty and the associated provisions referred to as the Stability and Growth Pact. Most ACs have debt levels below the 60% of GDP threshold of the Maastricht Treaty

¶17. (SBU) The average general government deficit in ACs, however, was 5.3% in 2002, according to Commission statistics. Only Estonia, Lithuania, and Slovenia have deficits below the 3% reference value. In several ACs, significant fiscal consolidation would be needed (Czech Republic, Hungary, Malta, and Slovakia all had deficits over 6% in 2002). The convergence reports will identify most ACs has having "excessive deficits." Unlike for EU member states, no sanctions can be imposed for having an excessive deficit. However, it also means the ACs can't join the EMU.

¶18. (SBU) Fiscal consolidation in order to meet the convergence criteria as soon as possible could result in lower public investment, particularly in infrastructure, which could adversely effect long-term growth. At the same time, reducing deficits might become even harder in the near future: requirements resulting from EU and NATO membership will lead to considerable pressure on spending in the coming years. The World Bank quotes estimates that put the overall costs of EU entry to the ACs, not exclusively but mostly budgetary, at as much as 3.5% of GDP for the first three years.

ERM II

18 (SBU) Growing appreciation that the exchange rate requirement might make the road towards adoption of the

euro rather bumpy has sparked off criticism from market participants, academics and policy-makers in the ACs.

¶19. (SBU) Daniel Gros of the Center for European Policy Studies in Brussels calls ERM II "the most dangerous exchange rate regime that one can imagine." Fixed but adjustable exchange rate regimes are a tempting target for speculators, in particular when the underlying economic fundamentals are shifting, in his opinion. Originally, capital inflows into the accession countries were mainly direct investments, either privatization or green-field investment. Gradually, portfolio investments are becoming more important, e.g. the "convergence play." These investments are short-term and can quickly flow out. This increases the risk of exchange rate volatility.

¶20. (SBU) Hungary's recent episode illustrates the problem. The Hungarian forint significantly appreciated over the last year due to strong capital inflows. The stronger forint hurt exports and, consequently, employment. In January, the National Bank of Hungary (NBH) cut interest rates to prevent too much portfolio investment and to protect the exchange rate. However, on June 4, the NBH weakened the central parity exchange rate by 2.26%. According to ECB officials, this was the result of a deal between the Government, which wanted a weaker exchange rate to stimulate exports, and the Central Bank, that wanted the government to fulfill the deficit convergence criteria quickly.

¶21. (SBU) The move was poorly communicated and misunderstood in the market that was spooked. The considerable depreciation of the forint prompted the NBH to increase interest rates again in the course of June in order to regain credibility for its anti-inflationary stance. These seesaw changes appear to have damaged the NBH's reputation. The episode also illustrates that a central bank only has one instrument (interest rates) to aim at two targets: exchange rate and inflation.

Debate Regarding Early Adoption of the Euro:
To Be In or Not To Be In.
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¶22. (SBU) Positions in the debate on early or later adoption of the euro are on predictable lines: ACs think sooner is better; member states advise to take time and do it right. From the ACs' perspective, capital movements present a potentially destabilizing force that could disrupt growth. This, in their view, could be avoided by early adoption of the euro, i.e. scraping the requirement of a two-year participation in ERM II. Advocates of early euro adoption generally also believe that the costs of a fixed exchange rate are low for the ACs. They are mostly small open economies and cannot really conduct an independent monetary policy anyway. Entering EMU would give them a say in monetary policy decisions.

¶23. (SBU) The Euro Group (finance ministers of the EMU member countries) takes a very different view. At its March 2003 meeting the Group discussed and reconfirmed its position that ACs are expected to first participate in ERM II for two years before being able to adopt the euro. At the April 15 informal Ecofin Council, ministers confirmed that they would neither accept early membership of ACs in ERM II, nor early exit from ERM II. According to the Ecofin approach, a certain "waiting period" before the adoption of the euro would allow ACs to cope with the shock of full integration into the single market and to achieve a high degree of nominal convergence.

¶24. (SBU) Commission research economists support the Euro Group's view for somewhat different reasons. They believe that ACs should wait to join ERM II to avoid an influx of capital and lower interest rates that do not reflect fundamentals. Lower interest rates could lead to unproductive investments and asset bubbles that would adversely affect the longer-term growth performance of the ACs.

¶25. (SBU) ECB chief economist Otmar Issing argues that as an intermediate regime, ERM II provides an anchor to expectations, while countries retain the flexibility to adjust the parity in case of asymmetric shocks and exchange rate pressures. He concedes, however, this option leaves countries exposed to changing conditions in global capital markets.

¶26. (SBU) Issing stresses that any decision to join ERM II must be consistent with an adequate level of nominal and real convergence with the euro area. This would reduce the risk of choosing an inappropriate parity for the exchange rate. In his view, the optimal timing of euro adoption may vary considerably between ACs. Moreover, Issing argues that two years' participation in the ERM is a minimum and a longer stay would permit ACs exchange rates to adapt to differences in productivity gains, wage growth and inflation

relative to the euro area. Once in EMU, these differences would translate in costly changes in competitiveness and economic activity, in his view.

¶27. (SBU) Interestingly, the IMF has tiptoed into this debate. In its Article IV consultation on Hungary the IMF staff stated that it "sees considerable merit in early adoption of the euro, provided fiscal discipline and wage restraint are vigorously pursued." The report went on to state that "for Hungary, a small economy already highly integrated with the EU, adopting the common European currency has clear medium-term benefits. This is particularly true given the important role in Hungary of FDI and foreign-owned enterprises, and their orientation mainly toward EU markets. The commitment to early EU accession and adoption of the euro not only hardens the authorities' resolve to deliver the necessary fiscal discipline and structural reforms, but it can also serve to strengthen the credibility of the disinflation path and, by doing so, can also help to minimize short-run costs that might arise."

Real convergence: Growth and economic structures
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¶28. (SBU) The Commission and the ECB have been publicly discouraging the ACs from entering EMU very quickly, recommending that they should first concentrate on raising per capita incomes closer to the EU average and moving towards comparable economic structures, e.g. real convergence. Commissioner Solbes has stressed that there are also significant risks associated with a premature EMU entry while the process of structural change, catching up and fiscal consolidation is not yet finished.

¶29. (SBU) Economic theory suggests that an important criterion for deciding whether to join a monetary union is whether economic cycles in the participating countries are pretty much in sync. This reduces the likelihood of asymmetric shocks hitting one or a few countries. Those subject to such shocks would have to absorb them without using monetary policy or exchange rates.

¶30. (SBU) How serious these limitations are for the ACs depends on the type of shocks, the degree of asymmetry of shocks compared to the euro area, and on the speed at which economies adjust to shocks. Polish and Hungarian central bank economists claim that economic cycles of the euro area and the ACs are basically aligned. An IMF staff study finds that there are still differences in the shocks and the subsequent adjustment processes between the euro area and the CEECs. However, several individual CEECs exhibit shocks and shock adjustment processes that are fairly similar to some euro area countries. For instance, Hungary, Estonia, and Latvia are not significantly different from Greece.

¶31. (SBU) An ECB official reports that their research continues to show a low correlation between cyclical developments in e.g. Poland and the euro area countries. Accordingly, he argued that an independent monetary policy would be good for a country like Poland. A Bundesbank official took the same view, stressing that the ACs recently had much stronger growth performance than the EU members, i.e. there is no sufficient degrees of cyclical synchronization. He also pointed out that even if this were the case, there would be an ongoing need for structural changes in relative prices during the catching-up process.

¶33. (SBU) ECB Executive Board Member Padoa-Schioppa pointed out that the convergence progress seems to be rather slow in most ACs when looking at per capita income levels. On average, per capita income stands at about 40% of the EU average as measured using purchasing power parities. However, according to Padoa-Schioppa, the most relevant concept of real convergence is assessing whether economic structures are in line with those of the euro area and whether new entrants have set up appropriate institutions and adopted international best practices and standards. He finds remarkable progress in that respect in the ACs.

ACs' views

¶34. (SBU) Benefits from adoption of the euro entail the elimination of exchange rate risk, reduction of transaction costs in cross-border business, increased trade, lower interest rates due to imported credibility and lower vulnerability to external shocks. For ACs with high debt levels and interest rates, such as Hungary, euro adoption would imply fiscal savings once interest rates are down to the euro zone level. Moreover, a commitment to enter the EMU by a time certain would intensify pressure on the government to pursue sound fiscal policies, signaling investors that public finances will be consolidated.

¶35. (SBU) The Slovenian central bank and government have stated that they aim at joining ERM II at the beginning of 2005. Thus the earliest date for the adoption of the euro would be 2007. It would still have to bring down its inflation rate (7.5% in 2002), but otherwise is not expected to have any problems with the convergence criteria. Meeting the criteria should be completely unproblematic for the three Baltic states (2002 general government deficit and inflation figures, respectively were: Estonia, 1.3%, 3.6%; Lativa, 2.5%, 1.9%; and Lithuania, 1.8% and 0.3%).
¶36. (SBU) The NBH and the Hungarian government have declared that they intend to adopt the euro as of January 1, 2008. Hungary plans to join ERM II soon after accession in 2004. Observers, however, doubt that Hungary will be able to meet the deficit (9.5% in 2002 projected by the Commission to fall to 4.9% in 2003) and inflation (5.3% in 2002; new forecast by NBH projects it to be 6.5% in 2004) criteria in time for the planned entry date. Poland (deficit 4.2%; inflation 1.9% in 2002) is aiming to adopt the euro by 2008 or 2009. Slovakia (deficit 7.7%; inflation 3.3% in 2002) has announced that it wants to join EMU as soon as possible.
¶37. (SBU) The Czechs (deficit 6.5%; inflation 1.4% in 2002) have been the only country to indicate that they are not in a hurry to join ERM II. They want to make sure that they will be able to meet the other criteria after two years of participation. However, should Poland and Hungary move quickly, the Czechs do not want to be seen as lagging. A strategy for the adoption of the euro will be established by the end of September
¶2003. The Czech finance ministry and central bank prefer to be prepared to adopt the euro by 2007, as they believe that financial markets might punish those ACs that are not ready when the other countries join EMU. The IMF staff shared that view in its Article IV Consultation with Czech authorities. The Prime Minister thinks that 2010 would be more appropriate.

The Politics: Rules as Pretext or Guideposts?

¶38. (SBU) While it is clear that the EU rules will be the touchstone to determine an ACs eligibility to adopt the euro, one senior AC central bank official claimed that strict adherence to the rules can be a pretext for other reasons against early adoption of the euro. He believes that the ECB is against early entry of the ACs because it would make monetary policy as well as ECB decision-making on other issues more difficult. "They are just not ready for us."
¶39. (SBU) An unspoken concern is that the entry of catching-up countries into EMU would result in a looser monetary stance. Although the GDP-weight of the ACs is negligible (6% of total euro area)under the new rotation system for ECB voting, the ACs weight in voting would be proportionately higher than their GDP. They could thus have a more significant influence on monetary policy decisions (even though the ECB has so far reached decisions by consensus and never taken a vote). In theory, however, ECB Council members should be guided by considerations regarding the entire euro area and not by national interests.
¶40. (SBU) On the other hand, the rules are not ironclad, rather serving a guideposts. ECB representatives have hinted that the Treaty leaves some scope for political decisions on EMU entry. "We just prepare the convergence report: it's just a report." Finance Ministers, after discussion the convergence reports, would direct the Commission to prepare a proposal for a decision by Heads of State or Government.
¶41. (SBU) In the application of the rules the Commission has stressed that (1) each country will be considered on its individual merits; and (2) each country will be treated equally. With respect to the first point, a Bundesbank expert doubted whether a country-by-country decision on EMU entry would take place. Rather he expects that there may be a group of more advanced countries, mainly the Baltics, joining early and another group following later. He also expects that political pressures will be exerted by the ACs to gain immediate entry into ERM II. To some ACs this would be the beginning of a two-year process leading directly to adoption of the euro.
¶42. (SBU) On the second point of equal treatment, neither Finland nor Italy spent two full years in ERM II before they joined EMU. Moreover, while the UK has never agreed to join the ERM II, there is speculation that it would nevertheless be admitted to EMU if it wished to enter. Sweden is a more immediate case in point. The Commission stated in its bi-annual report on Sweden that "exchange rate stability during a period of nonparticipation before entering the ERM II can be taken into account". Thus, previous experience suggests there is some leeway for ACs to be admitted to

EMU without participating in ERM for full two years.
¶43. (SBU) Similarly, Italy and Belgium did not meet the debt criteria before being allowed entry and some others may have used "creative accounting" to get their books in shape to meet the entry criteria. All these examples of interpreting rules are likely to be well-known to ACs.

Comment

¶44. (SBU) The potential gains of adopting the euro will be weighed against the potential risks, in particular of a real appreciation, which could put a brake on growth. The ACs themselves seem to understand that monetary, exchange-rate and fiscal discipline imposed by EMU can involve serious constraints, impeding growth.
¶45. (SBU) At the end of the day, the decision on EMU participation will be based on the rules and numbers, with a healthy dose of political considerations. However, watering down the convergence criteria for the ACs could harm the euro's reputation as a stable currency and would do the ACs no justice. Abiding by the rules and risking currency troubles that could be attributable, at least in part, to those rules also would not be a good advertisement for the euro. As in the past, some pragmatism could be used to reward those ACs that have demonstrated a commitment to move aggressively toward, if not actually meet, the Treaty criteria. End comment.
¶46. (U) This cable coordinated with Embassies Berlin, Budapest, Warsaw, Prague, Ljubljana, and USEU Brussels.

¶47. (U)POC: Claudia Ohly, Treasury Office, e-mail OhlyC@state.gov; tel. 49-(69)-7535-2367, fax 49-(69)-7535-2238.

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